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21pg Nos. 06-1457 and 06-1462

In the Supreme Court of the United States

MORGAN STANLEY CAPITAL GROUP INC., PETITIONER,

v.

PUBLIC UTILITY DISTRICT NO. 1 OF SNOHOMISH COUNTY, WASHINGTON, *ET AL*, RESPONDENTS.

CALPINE ENERGY SERVICES, L.P., *ET AL*, PETITIONERS,

v.

PUBLIC UTILITY DISTRICT NO. 1 OF SNOHOMISH COUNTY, WASHINGTON, *ET AL.*, RESPONDENTS.

On Writ of Certiorari to the United States Court of Appeals for the Ninth Circuit

BRIEF FOR THE STATES OF ILLINOIS, CONNECTICUT, IOWA, MASSACHUSETTS, MINNESOTA, MONTANA, NEW HAMPSHIRE, OKLAHOMA, AND RHODE ISLAND AS *AMICI CURIAE* IN SUPPORT OF RESPONDENTS

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QUESTION PRESENTED

Whether, in response to complaints filed under § 206 of the Federal Power Act, 16 U.S.C. § 824e, the Federal Energy Regulatory Commission misconstrued the public interest standard established by this Court in *United Gas Pipe Line Co. v. Mobile Gas Serv. Corp.*, 350 U.S. 332 (1956), and *Federal Power Comm'n v. Sierra Pacific Power Co.*, 350 U.S. 348 (1956).

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INTEREST OF THE *AMICI CURIAE*[1]

This case asks whether the Federal Energy Regulatory Commission ("FERC") misapplied this Court's decisions in *United Gas Pipe Line Co. v. Mobile Gas Serv. Corp.*, 350 U.S. 332 (1956), and *Federal Power Comm'n v. Sierra Pacific Power Co.*, 350 U.S. 348 (1956) (together, "*Mobile-Sierra*"), in refusing to modify wholesale electricity contracts.[2] Because state-regulated utilities across the country increasingly purchase electricity in FERC-regulated markets, and because FERC alone determines whether wholesale electricity prices are lawful, this case is of critical interest to the *amici* States.

Resolution of the question presented is likely to have a particular impact on States that have deregulated and/or restructured their electricity sectors. In these States, public utilities rely on the

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[1] Pursuant to this Court's Rule 37.2(a), the *amici curiae* provided notice of their intention to file this brief to counsel of record at least 10 days prior to its filing.

[2] Under these contracts, petitioners sold electricity to various entities, including public utilities, which purchased power to provide service to retail customers. These entities, as well as state agencies charged with protecting the interests of retail customers, are the respondents and intervenors in this case. Pet. App. 2a, 316a. (All citations to "Pet. App." in this brief refer to the appendix filed by petitioner Morgan Stanley in No. 06-1457.)

wholesale markets heavily, and in some cases exclusively, to purchase electricity for their retail customers. Indeed, even States with a traditional regulatory framework, in which public utilities both generate and supply electricity at retail, will be affected by the outcome of this case, for public utilities in these States routinely purchase electricity at wholesale to supplement the electricity they generate themselves.

As a result of this increased reliance on the wholesale markets to purchase electricity for consumer use, retail rates in many States depend largely on FERC-regulated wholesale prices. Moreover, because the Federal Power Act ("FPA" or "Act") gives FERC exclusive jurisdiction over wholesale markets, see 16 U.S.C. § 824d(a), wholesale prices are not subject to regulation by the States. Consequently, if FERC fails to ensure that wholesale rates are lawful—and fails to modify rates that are not—States cannot adequately protect their retail customers.

STATEMENT

1. Sections 205 and 206 of the FPA set forth the standards by which FERC regulates rates for the sale of electricity at wholesale. Section 205 requires that all such rates "be just and reasonable" and declares "unlawful" any rate failing to meet that standard. 16 U.S.C. § 824d(a). Section 206 then provides that, if FERC determines that a wholesale rate is "unjust, unreasonable, unduly discriminatory

or preferential," FERC "shall determine the just and reasonable rate" and "shall fix the same by order." *Id.* § 824e(a).

2. In late 2001 and 2002, respondents filed complaints pursuant to § 206, seeking FERC review of certain wholesale electricity contracts between respondents and petitioners. Pet. App. 247a; J.A. 1484a. The complaints alleged that the contract prices were unreasonably high because, at the time the contracts were negotiated in 2000 and 2001, electricity markets in the western United States were dysfunctional. Pet. App. 247a-248a; J.A. 1485a. The complaints asked FERC to modify the contracts to render the terms just and reasonable. *Ibid.*

3. FERC concluded that the contracts were not contrary to "the public interest" and therefore denied respondents' requests, purporting to apply the so-called "*Mobile-Sierra* doctrine." Pet. App. 248a-249a. *Mobile* and *Sierra*, two cases decided on the same day in 1956, involved requests by a natural gas distributor and an electricity supplier, respectively, to increase rates in their existing contracts. Although the Court rejected both requests to change the rates in those cases, it established FERC's authority to modify existing contracts to protect the public interest. See *Mobile*, 350 U.S. at 344 (holding that FERC may modify wholesale natural gas contracts "when necessary to protect the public interest"); *Sierra*, 350 U.S. at 355 (holding that FERC may modify wholesale electricity contracts that "adversely affect the public interest").

Accordingly, while natural gas companies may not change their contracts "simply because it is in their private interests to do so," the law affords them "an avenue of relief when their interests coincide with the public interest." *Mobile*, 350 U.S. at 344. The Court characterized this as "a reasonable accommodation between the conflicting interests of contract stability on the one hand and public regulation on the other." *Ibid.*

In *Sierra*, the Court identified factors that may be used in determining whether a rate is so low that it imperils the public interest—namely, whether the rate threatens to "impair the financial ability of the public utility to continue its service, cast upon other consumers an excessive burden, or be unduly discriminatory." 350 U.S. at 355. The Court emphasized, however, that "a contract may not be said to be either 'unjust' or 'unreasonable' simply because it is unprofitable to the public utility." *Ibid.*

4. FERC purported to apply the *Mobile-Sierra* "public interest" test to the contracts at issue in this case—but in a form that FERC acknowledged would render the standard for contract modification "practically insurmountable." Pet. App. 209a. Concluding that the contracts failed to satisfy this standard, FERC limited its analysis to the examples from *Sierra* and held, specifically, that the agreements did not cause the utility respondents "financial distress" sufficient "to threaten their ability to continue service * * * [or] cast an excessive burden on their customers." *Id.* at 252a. Nor were

the contracts "unduly discriminatory to the detriment of other customers." *Ibid.*

5. On respondents' petition for review of the FERC orders, the Ninth Circuit reversed, holding that FERC's application of *Mobile-Sierra* was both procedurally and substantively flawed. *Id.* at 3a. First, FERC erred procedurally by applying the *Mobile-Sierra* public interest standard at all, for that standard does not apply to contracts negotiated in a dysfunctional market that fails to produce the just and reasonable prices that the FPA requires. *Id.* at 42a-60a. Second, even if the *Mobile-Sierra* standard does control, FERC misapplied it by focusing solely on the extent to which the contracts placed an "excessive burden" on respondents and their retail customers, without comparing the contract prices to the marginal cost of producing electricity to ensure that those prices were within the "zone of reasonableness." *Id.* at 63a-65a. The court of appeals remanded for FERC to determine whether review under *Mobile-Sierra* is proper in this case and, if so, to apply that standard correctly. *Id.* at 66a-67a.

SUMMARY OF THE ARGUMENT

The Ninth Circuit properly rejected FERC's misinterpretation of this Court's holdings in *Mobile* and *Sierra*.[3] As the court of appeals recognized, the *Mobile-Sierra* doctrine necessarily implies what amounts to an economic test, under which the "public interest" inquiry turns on a comparison between the contract price and the marginal cost incurred in producing the electricity. If the wholesale supplier contracts to sell at a price either significantly above or below its marginal cost, the test holds that the public interest is threatened, and FERC must modify the contract price. The standard applicable to high-rate challenges (like this one) is identical to that applied to the low-rate claims in *Mobile* and *Sierra*—either way, what matters is whether the contract price strays significantly from marginal cost.

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[3] The *amici* States adopt respondents' argument that, as a procedural matter, FERC erred in applying the *Mobile-Sierra* public interest standard without first determining that the contracts, which were negotiated in a market so dysfunctional that even FERC calls it "the worst electricity-market crisis in American history," FERC Br. Op. 12; FERC Br. 16, were just and reasonable. See Snohomish Br. 28-49; GSWC Br. 28-51; CPUC Br. 19-54. This brief argues that FERC substantively misinterpreted *Mobile* and *Sierra* and, as a result, used the wrong standard to determine whether the contracts at issue were contrary to the public interest.

Rather than undertake the comparison between price and marginal cost that *Mobile-Sierra* demands, FERC mistakenly limited its inquiry to the burdens on respondent utilities and their retail customers. Not only is this approach inconsistent with *Mobile* and *Sierra*, but it is impossible to square with other decisions from this Court and ignores the practical realities of state public utility regulation.

Accordingly, the *amici* States urge this Court to affirm the judgment of the Ninth Circuit. On remand, FERC must compare the contract prices with the marginal cost of producing the electricity, as *Mobile-Sierra* requires, and modify the challenged contracts if these figures are not reasonably close.

ARGUMENT

FERC fundamentally misinterpreted the *Mobile-Sierra* test. As the Ninth Circuit correctly determined, that test requires FERC to compare contract prices with the marginal costs of electricity production. This approach follows not only from *Mobile* and *Sierra*, but from bedrock economic principles favoring a close connection between price and marginal cost. Moreover, FERC's "practically insurmountable" alternative test—which asks whether contract prices threaten "financial distress" for the wholesale buyer and place an "excessive burden" on consumers—cannot be reconciled with decisions of this Court and ignores the practical realities of state public utility regulation.

I. The "Public Interest" Inquiry Properly Turns On A Comparison Between Price And Marginal Cost.

It is undisputed that FERC may modify contract rates that are "so low as to conflict with the public interest," *Mobile*, 350 U.S. at 345, such that the rates threaten to "impair the financial ability of the public utility to continue its service, cast upon other consumers an excessive burden, or [are] unduly discriminatory," *Sierra*, 350 U.S. at 355. In short, it is neither in the public interest for an electricity supplier to jeopardize its financial integrity by selling at a loss, nor for it to favor one customer and cover its marginal costs by selling to others at higher prices. Under either circumstance, FERC can and should exercise its authority to modify the contract rate.

At the same time, it is not enough that a contract price is "unprofitable to a public utility," for § 206 enables FERC to protect "the public interest, as distinguished from the private interests of the utilities." *Sierra*, 350 U.S. at 355. Thus, the Court drew a critical distinction between a price that impairs the financial ability of a public utility to operate and a rate that is sustainable but unprofitable. This distinction may be expressed in simple economic terms: it is in the public interest to increase the utility's contract price when that price is less than the marginal cost of producing the electricity. Indeed, an enterprise need not charge prices in excess of marginal cost to be sustainable,

but it must cover its marginal expenses. See I Alfred E. Kahn, *The Economics of Regulation: Principles & Institutions* 67 (1988) ("[I]t pays * * * to continue to produce and sell as long as * * * incremental revenues cover * * * incremental cost."). The negative effects of underpricing that *Mobile-Sierra* uses as examples of a threat to the public interest follow inexorably from pricing below marginal cost, for, to remain viable, a producer selling below cost must choose between discontinuing service or subsidizing the low-price contract by burdening other customers with higher prices, precisely the ills that *Mobile-Sierra* empowers FERC to prevent in the public interest.

The converse is also true. It is well-established that prices significantly above marginal cost arise only in imperfectly competitive markets, and that such prices lead to the misallocation of resources. See Kahn, *supra*, at 66. Accordingly, in order to maximize utility "from society's limited aggregate productive capacity * * * prices * * * for * * * various goods and services * * * must accurately reflect their respective [marginal] opportunity costs." *Ibid.*

The Ninth Circuit thus correctly applied the marginal cost test derived from *Mobile-Sierra* to respondents' claim that their contract rates are too *high*. The court of appeals recognized that "a functioning marketplace will drive prices toward marginal cost," Pet. App. 64a, and properly determined that *Mobile-Sierra* requires the

wholesale contract price to fall within a "reasonable range" of marginal cost:

> [e]ven if a particular rate exceeds marginal cost[,] * * * it may still be within this reasonable range—or "zone of reasonableness"—if that higher-than-cost-based price results from normal market forces and is part of a general trend toward rates that do reflect costs.

Ibid. The court correctly concluded that "the proper standard for the *Mobile-Sierra* 'public interest' mode of review in a high-rate challenge is whether the wholesale energy contract price is outside the 'zone of reasonableness,'" too high relative to marginal cost. *Id.* at 65a.

Accordingly, petitioners are wrong to say that the Ninth Circuit held that "application of the [*Mobile-Sierra*] standard must be asymmetrical," Calpine Br. 47, and specifically that the court of appeals applied a less rigorous test to determine whether a contract price is too high than *Mobile* and *Sierra* applied to alleged underpricing, *id.* at 52-56; Morgan Stanley Br. 48-50. In fact, the court of appeals asked precisely the question that follows from *Mobile-Sierra*—whether the contract price is significantly out of line with marginal cost.

The court thus held that "FERC should have performed a more sophisticated economic analysis to determine if the challenged contract affected the

public interest." Pet. App. 66a. In particular, FERC should have analyzed the marginal cost of generating the electricity needed to fulfill the terms of the contracts. Because FERC did not collect or analyze data on the cost of generating the electricity supplied to respondents, moreover, it is impossible to determine conclusively whether the contracted rates depart impermissibly from marginal cost.[4] These costs are readily ascertainable on remand, however, and if FERC determines that a contract price is significantly higher than marginal cost, FERC must modify the contract price accordingly.

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[4] The contract prices at issue here may have been significantly above the marginal cost of generating the electricity needed to supply the contracts. Since the electric systems are typically operated by first deploying the low-cost generators (typically, nuclear- and coal-powered), and by operating the high-cost generators (powered by natural gas) only during peak demand periods, the marginal cost of generating electricity is usually much lower during off-peak than peak periods. Thus, the marginal cost—which would be expressed in dollars per megawatt-hour ("MWH")—of producing electricity to fulfill a hypothetical contract to supply electricity around the clock for a year might be less than $30/MWH 90% of the time (during nonsummer months and on summer nights, when only low-cost generators are operating), and may exceed $100/MWH as little as 1% of the time (on hot summer afternoons, when high-cost generators are brought on line to meet the increased demand caused by air-conditioning use). The contracts in this case called for payment of as much as $290/MWH, even during off-peak periods, when the marginal cost of generating electricity is low. Pet. App. 30a.

II. The "Public Interest" Test That FERC Applied Is Incompatible With The Decisions Of This Court And Ignores The Practical Realities Of State Utility Regulation.

Rather than compare price and marginal cost, as the reasoning in *Mobile-Sierra* and fundamental economics require, FERC asked whether the contract prices caused "financial distress" for respondents, the wholesale electricity buyers, sufficient to threaten their viability or placed "an excessive burden" on the ultimate consumer. Pet. App. 252a. This approach is not only impossible to square with the principle underlying *Mobile-Sierra*, but runs afoul of other decisions by this Court and ignores the realities of state public utility regulation.

First, requiring "an excessive burden" on the consumer before FERC will modify a contract price violates this Court's "'small dent' admonition." Pet. App. 64a. This Court has long recognized that:

> [i]n the context of ratemaking, it is typically the case that any increment in the rate will "make a small dent in the consumer's pocket," *FPC v. Texaco Inc.*, 417 U.S. 380, 399 (1974), while that same increment will have substantial consequences for the parties to whom the rate is paid. FERC's statutory mandate to prescribe a rate that "shall be just and reasonable to the electric consumers of the electric utility," 16 U.S.C. 824a-3(b)(1)

> (1976 ed., Supp. V), obviously reflects a congressional determination that potential savings for consumers as a class are important even though rate changes will generally not have great economic significance for any individual consumer.

American Paper Inst. v. American Elec. Power, 461 U.S. 402, 417 n.11 (1983). In short, the impact on consumer rates need not be "excessive" to impair the public interest. To the contrary, "'even a small dent in the consumer's pocket'"—so long as that increase arises from a contract price that is outside the zone of reasonableness—may warrant contract modification under *Mobile-Sierra*, as the Ninth Circuit correctly held. Pet. App. 64a (quoting *Texaco*, 417 U.S. at 399). Indeed, to require "an excessive burden" on the end user is to abandon *Mobile-Sierra* for the "practically insurmountable" test that FERC applied. Pet. App. 209a.

Second, the practical realities of utility regulation make it nonsensical to define the "public interest" entirely in terms of the contract rate's effect on the wholesale buyer's viability and on the "excessive[ness]" of the retail price. These factors often have an inverse relation—the more the wholesale buyer is able to pass along wholesale price increases to the end user in the form of higher retail rates, the smaller the effect of an increase on the wholesale buyer and the greater its effect on the ultimate consumer. Likewise, this Court has noted that increases in wholesale rates need not lead to an

increase in retail rates at all, if savings in other areas offset the wholesale rate increase. See *Nantahala Power & Light Co. v. Thornburg*, 476 U.S. 953, 967-968 (1986).

State commissions decide the extent to which regulated utilities may pass these costs along to consumers, depending on a variety of factors including public acceptability, rate stability, and fairness to the various consumer classes.[5] The more the wholesale buyer is allowed to pass along price increases to the end user in the form of higher retail rates, the smaller the effect of a price increase on the wholesale buyer and the greater its effect on the ultimate consumer. As a result, it is impossible for FERC to determine accurately whether wholesale contract prices are contrary to the public interest by looking selectively at retail rates at fixed points in time, as it did here, Pet. App. 210a-220a, and nonsensical in any event to define the "public interest" in terms of two criteria that are frequently inversely related. For instance, a utility may be able to avoid bankruptcy—but only if retail rates skyrocket. That is, injury to the public utility can be avoided by harming its customers. Conversely, retail customers may benefit if the public utility fully absorbs a wholesale rate increase, but doing so may

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[5] For a complete list of criteria that state utility commissions use to develop a sound rate structure, see James Bonbright, *Principles of Utility Rates* 291 (1961).

cause the public utility to go bankrupt. Neither scenario is in the public interest.

If FERC fails to ensure that wholesale rates are just and reasonable and that wholesale contracts are in the public interest, States will be faced with unworkable choices, and, moreover, will not be able to protect retail utilities or their customers adequately. In short, FERC needs to do its job, so States can properly do theirs.

CONCLUSION

The judgment of the court of appeals should be affirmed.

Respectfully submitted,

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